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Westly Proposes \$1 Billion Plan to Help Close Budget Gap

Plan Could Save Services for Children and Families

SACRAMENTO, CA – State Controller Steve Westly today proposed a \$1 billion plan to crack down on the underground economy, collect unpaid taxes and use performance audits to reduce waste in government. Westly's proposal could spare services for children and low-income families from budget cuts.

"Before we talk about cutting services for the most vulnerable Californians, we need to take a hard look at ways to save the state money," Westly said.

Underground Economy

Westly's plan cracks down on employers who pay cash wages under the table and businesses that fail to fully report their income, known as the underground economy. This part of the plan could generate \$340-\$410 million by:

- a. Using technology to make tax collection agencies' auditing more effective;
- b. Increasing enforcement tools;
- c. Establishing an amnesty program to increase revenue collection.

Collecting Unpaid Taxes

As chair of the Franchise Tax Board, Westly supported recent legislation (SB 614, Cedillo & Burton; AB 1601, Frommer) that provides stiffer penalties for people who used abusive tax shelters. The initiative will collect \$135-\$185 million more revenue than anticipated.

Cutting Waste in Government

Additionally, the plan calls for reinstating the Controller's discretion to conduct performance audits. Currently, the Controller's Office uses financial audits to save \$200 million per year. The Controller could identify \$200-\$400 million more by using performance audits to show how state programs can more effectively spend taxpayer dollars.

Westly pointed to the impact of severe budget cuts on the lives of millions of Californians.

"For a billion dollars, we could provide health insurance for 800,000 children, provide life-saving drugs for 100,000 low-income HIV and AIDS patients or provide in-home support services to tens of thousands of California seniors," Westly added.

Attached is a detailed description of the Westly \$1 Billion Plan.

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VOLUNTARY COMPLIANCE INITIATIVE

Cracking Down on Tax Shelter Abuse

\$135 to \$185 M

Overview

In 2003, legislation was enacted to create the Voluntary Compliance Initiative (VCI), a one-time amnesty period for taxpayers who used abusive tax shelters to amend their state tax returns before the state starts pursuing the harsher penalties authorized by new laws (SB 614, Cedillo & Burton, 2003; AB 1601, Frommer, 2003.) The initiative set an April 15, 2004 deadline for taxpayers to amend their returns and fully pay the tax and interest due.

The Franchise Tax Board (FTB) estimates that California loses between \$600 million and \$1 billion in tax money annually through abusive tax shelters. Most abusive tax shelters involve moving money through many layers, domestic and foreign, such as partnerships, S corporations, and limited liability companies. In the end, the taxpayer claims a loss even though no income has truly been lost; rather the money has been moved around to give the impression of a loss. The extra layers make it extremely difficult for auditors to track because multiple states and counties may be involved.

These abusive tax shelters stand in contrast to legitimate tax deductions like home purchases, which allow deductions for interest paid or other losses.

Many promoters inappropriately market abusive tax shelters as a legal way to reduce a taxpayer's tax liability. The arrangements often involve confidentiality clauses that forbid a taxpayer from disclosing the terms, citing the promoter's proprietary information.

Some taxpayers are truly victims of poor financial advice, and the Voluntary Compliance Initiative is their opportunity to correct errors without paying harsh penalties.

Budget Impact

The Voluntary Compliance Initiative initially was expected to bring in \$90 million. To date, however, the FTB has collected \$119 million. The program is now expected to collect \$225 to \$275 million. That means \$135 to \$185 million in additional revenue can be added to the state's bottom line.

In addition to the VCI monies collected by April 15, 2004, the program will continue to generate revenue from an extensive list of possible participants. The law requires promoters of abusive tax shelters to surrender their list of clients, which will allow FTB to pursue those who don't comply voluntarily.

PERFORMANCE AUDITS

\$200 to \$400M

Cutting Waste and Using Tax Dollars More Efficiently

Overview

Performance audits enable the Controller's audit staff to independently assess the overall performance and management of state programs with the goal of ensuring that taxpayer dollars are being utilized as efficiently as possible. The audits provide program managers with information to improve their operations, as well as incorporate best practices and learn about crosscutting issues from across California government.

Since the implementation of the 1998 Budget Act, the State Controller has been prohibited from using appropriated funds to conduct a performance review or performance audit. As a result, the Controller only conducts financial audits of state and local government programs, which currently result in annual savings of \$200 million. The Controller seeks to lift the budget restriction on performance audits and estimates an additional annual savings of \$200 to \$400 million.

If the budget restriction is lifted, the Controller intends to work with the Administration and the Legislature to identify the state's top priorities for performance audits. Examples include:

- Department of Health Services – For the 2003-04 fiscal year, the Medi-Cal program is expected to incur \$29.5 billion in expenditures. Of this amount, approximately \$10 billion comes from the State General Fund and the remainder from federal Medicaid funds. The Controller's Office believes that there are plenty of opportunities to achieve significant program savings. For example, past reports on the Medi-Cal Drug Rebate Program indicate hundreds of million dollars in drug rebates – dating as far back as 1994 – owed to the state by drug manufacturers but uncollected, despite staff resources specifically budgeted to collect these rebates. A performance audit could evaluate and identify operational changes necessary to collect the rebates and ensure that monies are received on a timely basis going forward.
- Department of Corrections – California annually spends over \$5 billion to run its prison system. The fact that the prison system is plagued with waste, fraud, and inefficiencies has been well documented. For example, despite spending close to \$1 billion on health care for prisoners, or \$6,000 per inmate, the Department of Corrections continues to face severe criticism (and lawsuits) over the quality of health care being provided to inmates. While the Department last year began to take steps to improve the prison medical system, a performance audit would recommend steps necessary to shift toward a more cost-effective system expected to result in significant budget savings.
- Department of Social Services – A 2002 federal review of the state's child welfare services program identified significant problems with state oversight of county welfare programs and required DSS to submit a performance improvement plan committed to specific corrective actions. A performance audit could recommend the most efficient and effective ways to correct the fiscal and management problems that impact the welfare of children in order to avoid a potential \$18 million penalty.

Budget Impact

The Controller estimates that performance audits could generate annual budget savings of \$200 to \$400 million, depending on the types of audits conducted and staff resources available.

TAX MEASURES

\$340 to \$410 M

Cracking Down on Tax Cheats and the Underground Economy

Overview

Each year, California loses approximately \$3 billion in income tax revenue because employers pay sub-minimum wages and cash under the table, and businesses fail to fully report their income. To target tax cheats and crack down on California's underground economy, the Controller is proposing new enforcement and deterrent measures aimed at stopping the underground economy.

Specific initiatives include:

- Enhanced and targeted auditing using technology and data to make tax collection agencies' auditing more effective. (\$80 to \$90 million)
 - Match income source data that FTB receives to income reported on tax returns.
 - Obtain more data from more sources to match against tax returns filed or not filed.
 - Identify taxpayers with questionable income withholding status.
 - Expand auditing activities by lowering FTB thresholds.
- Stepped-up enforcement through increased penalties and targeted programs. (\$70 to \$90 million)
 - Reinstate the misdemeanor program to penalize taxpayers for underreporting of income.
 - Create a special task force to deal with abusive tax shelters.
 - Conduct audits of tax preparers who knowingly enable the filing of false tax returns.
 - Revise income withholding requirements for specific types of income (i.e. gambling winnings) to ensure taxes are paid and not incorrectly refunded.
 - Expand tax collection activities by lowering FTB thresholds.
- New and expanded amnesty programs to accelerate revenue and encourage faster voluntary compliance before enforcement kicks in. (\$190 to \$230 million)
 - Establish new amnesty programs to accelerate revenue and encourage faster voluntary compliance.
 - Extend revenue acceleration proposal aimed at high-income individuals.

BUDGET IMPACT

The Controller estimates that the package of tax enforcement and deterrent measures will result in new and accelerated revenue of \$340 to \$410 million, depending on staff resources.